During the first nine months of 2009 we have seen over $30 billion of new issuance of Non-GSE (aka private label) residential mortgage securitizations that are using other RMBS transactions for collateral. In industry parlance, these “re” securitizations are known as re-REMICs. This spike in volume reflects the fact that the underlying securities, all originally purchased with an AAA rating and thought to have little or no credit risk, have either already been, or are likely to be, downgraded. Thus they are no longer eligible investments for many market participants, including many current holders. Within Prime, Alt-A, and Subprime, virtually all of the 2006 and 2007 AAA securities, and most of the 2005 securities, are likely to take credit losses and to be rated as Defaulted by the end of this cycle. It is important to understand that the fundamental performance of the loans supporting the 2005, 2006, and 2007 vintage deals is stunningly awful. However, the negative rating migration places additional downward pressure on these asset prices. Properly structured re-REMICs can alleviate much of the price pressures that arise from these technical issues by reallocating the cash flows of these underlying securities to create new, properly enhanced, AAA securities that better meet the needs of investors, usually by adding more subordination to the senior security.

In this article, we look at current day re-REMICs, making the point that most are far better designed than either the underlying collateral or the previous generation of re-REMICs. The new “super duper” tranche has more locked-out credit enhancement than ever before. And, given the current market dislocations, these securities can be sold at yields that look appealing versus other “safe” alternatives. The mezzanine tranches carved from re-REMICs are more explicitly levered credit bets. In a few of these deals, an exchangeable structure is employed on at least some of the tranches (similar to the MACR—modifiable and combinable REMIC certificate—structure in Freddie Mac CMOs), providing further flexibility. We believe that all re-REMICs should be broken down into component building blocks to allow for flexibility going forward. The re-REMICs in turn provide an important technical support for the private label RMBS market, as it increases the buyer base for these securities.

**The Value of a Re-REMIC**

The prices for RMBS assets are low primarily as a function of the horrific performance of the shoddily underwritten loans backing the securities. However, pricing pressures are exacerbated by two technical issues that can be addressed by re-REMICs.

1. **Funding Costs.** The traditional holders of a private label AAA RMBS are banks,
insurance companies, and pension funds. Banks and insurance companies fund their investments with 8%–10% equity with the balance of funding supplied by such regulated sources as deposits or annuities. Equity is, of course, the most expensive form of capital, while regulated sources are the least expensive. With fixed costs of equity and regulated debt, investments become more or less attractive when compared by their blended cost of funding or “leveragability.” A bank, for example, may only need to supply 1.6% of the equity to purchase an AAA rated bond, while a CCC rated bond will require 100% equity (equity charge is based on the price at which the bond is marked). The slope between the absolute costs of equity versus regulated debt is at or near an all-time high. Equity investors today are seeking 15%–20% returns while bank deposits are yielding 2% and 5-year annuities, offered by insurance companies, are yielding about 4%. The math here is fairly simple. A bank can fund a AAA asset, yielding 2.3%, with 98.4% deposits and 1.6% equity, to produce a 20.75% yield for the equity investor (2.3% + ((98.4%)/1.6%) * 0.3%). Meanwhile, a CCC asset, which cannot be levered, would need to produce a yield of 20.75% to produce the same 20.75% return on equity. Depending on the term to maturity and the coupon, this 1,845 basis point slope will have a huge impact on asset prices. For example, on a five-year investment carrying a 2.3% per annum coupon, the differences in funding cost would require a 54.3 point price discount for the lower-rated asset. This is admittedly an extreme example, as a bank would not lever a AAA asset. 61.5 to 1.

2. Supply/Demand Imbalance. The overall capital available to “junk” fixed-income assets is of course a fraction of that available to AAA rated assets. Given that downgrades have occurred and are expected to increase dramatically, there is a massive imbalance between the supply of poorly rated assets and the capital available to absorb them. At the asset level, there is also an additional problem of sizing. The fixed-income portfolio management industry can broadly be broken down into two groups: those that manage credit risk and those that manage interest rate risk. Clearly, the AAA rated assets are designed to appeal to the managers of interest rate risk as the credit risk has presumably been neutralized. These two groups of managers have distinctly different views on portfolio diversification. While credit managers thrive on diversity, interest rate managers prefer fewer positions to manage. This feature of the market creates dislocations when we have such a large volume of downgrades. When these fallen assets come to market, it is often in sizes inappropriate for the bulk of credit managers.

AN EXAMPLE

To illustrate what we feel is the correct approach to the re-REMIC process, we will provide a detailed review of a transaction done in early 2009; we selected this deal because the exact same RMBS class was used in a re-REMIC in late 2008. This gives us a fairly glaring example of the changes in enhancement requirements through time.

The original RMBS used in these two recent re-REMICs is the senior-most class from a 2007 vintage 1st Lien Securitization brought to market by Washington Mutual in May 2007. The loans in this pool were considered by the market to be “Prime” in nature, and therefore the rating agencies required the most senior classes to hold 5.25% original credit enhancement in order to achieve a AAA rating. In other words, this enhancement level was deemed sufficient to provide the AAA securities holders protection in the event pool losses actually were a multiple of expected losses. By the time this deal came to market, however, it had become standard for AAA buyers to require securitizers to provide double the enhancement required by the ratings agencies. Thus was born WAMU 2007-HY6 Class 1A1. The borrowers had been signed up for loans where the rate would remain fixed for five years and thereafter would float semi-annually at a rate of 229 bps over the one-year LIBOR. The 1A1 investor would be shielded from losses by two different types of subordinate classes, one of which would be 5.25% of the deal and would not be allowed to amortize for several years and not until several significant performance metrics and been met. The other subordinate class would be an additional 5% of the transaction size. However, this subordinate would be allowed to amortize alongside the 1A1. Thus, at the original closing, the 1A1 Class would be roughly 90% of the liability structure of the RMBS.

The troubling issue is, of course, the fundamental performance of the “Prime” loans in this WAMU securitization. By the end of February 2009, the borrowers...
had experienced 22 of their planned 360 scheduled payment dates and none of them had seen any rate changes. Unfortunately, 16.8% of them had fallen 60 or more days delinquent. For the 1A1 class to mature without taking a loss, this pool will need to recover 89.4% of the remaining loan balances. With 16.8% already in default, this obviously seems like an unlikely outcome. In fact, our estimate is for both subordinate classes to be fully depleted in January of 2011. This will of course leave the 1A1 Class exposed to all losses beyond January 2011.

This bond is a very good example of the treacherous ratings errors and subsequent slide that are found in structured finance. The rating agencies determined in May 2007 that a bond like this needed 5.25% credit enhancement (CE) to achieve a AAA rating. This class, which was almost double enhanced, was rated “B” by Standard and Poor’s in April 2009, having been downgraded to “AA” in December 2008 and to “B” only three payments later, in March 2009. Fitch reviewed the rating on April 4, 2009, and downgraded the bond from AAA to CC in one move.

WAMU 2007-HY6 1A1 in its current incarnation simply does not fit the current marketplace. The rating is so low that a regulated entity would incur high, risk-based capital charges for this security. For a current rating of B, a bank would need to hold a dollar-for-dollar capital charge for such a security (versus 1.6% for an AAA rated security). For insurance company holders, this security would likely receive a NAIC 5 rating, consistent with its Fitch CC rating (when there are two ratings, the lower of the two is the one used for capital charge purposes), requiring a 17% capital charge (versus 0.3% for AAA). With regulated investors off-limits, the universe of fixed-income investors dwindles quickly. Distressed debt managers generally seek corporate credit risk and have a strict limitation on the amount of structure finance transactions they can hold, and the mortgage-only alternative asset managers are simply not large enough and have far too expensive capital to provide much support.

The market has clearly found one possible solution to the liquidity problem—re-REMIC this bond to re-create a AAA rated asset that does fit the usual fixed-income investors along with a riskier and more leveraged asset for investors that seek higher-yielding instruments with credit risk. In the re-REMIC, the senior class can be viewed as term funding for a position in the underlying asset. A re-REMIC is very attractive in that it expands the buying power of those investors truly trying to leverage their credit expertise, while simultaneously cleaning up these so called “toxic assets” and providing a high-grade investment alternative to investors being forced into lower margin products by quantitative easing.

The truly unique situation on this particular deal is that the 1A1 class was used in two re-REMICs which were rated only three months apart. ASG 2009-1 A60, was priced in early March 2009 and was settled later that month. The other transaction was WAMR 08-1 3A1, priced and settled in December 2008. Both structures were very straightforward; the senior classes are to be paid in full before any principal is released to the subordinate classes. The only difference is the sizing of the senior classes. In the December 2008 deal (WAMR 08-1 3A1), the senior class composed 75% of the deal and is currently rated AAA by both S&P and DBRS. In the second re-REMIC, ASG 09-1 A60, the front bond is composed of the front 60% of the cash flows, and the security was rated AAA by Fitch and DBRS. It is worth noting that the subordination requirement for a Prime pool increased from 5% to 35% between issue date and December 2008 (19 months) and again from 35% to 50% in the three months between December 2008 and March 2009. Given that these are first lien mortgages with expected losses upon default of roughly 50%, an increase in 15% required subordination implies an increase to cumulative defaults of 30% (from 60% to 90%, for example). With this increase in subordination levels, we believe that the odds of underestimating default and loss potential have been greatly reduced.

Exhibit 1 shows the difference in average lives and principal windows between the original collateral and the front cash flows on the WAMR 08-1 3A1 and ASG 09-1 A60. Note that at 10% CPR (the average speed for the past six months), the original security (employing a pass-through structure) has an average life of 7.38 years and a window that extends to 2037. The first re-REMIC, WAMR 08-1 3A1, has an average life of 4.33 years and a window that extends to 2019. The second re-REMIC, ASG 09-1 A60, has an average life of 3.22 years and a window that extends to 2016. The progressively shorter average lives and windows are, quite simply, a function of the fact that prepayments on the entire deal (inclusive of liquidation proceeds) are being channeled to the front sequential. The smaller the proportion of the deal getting all prepayments and liquidation proceeds, the faster the front sequential security is paid down, hence the shorter it is.
Although the pool has high delinquencies and many still-performing high-LTV loans are in portfolio, the majority of borrowers in this pool still have significant equity in their homes. Exhibit 2 uses the Amherst Loan Information Analysis System (ALIAS) to dissect this rather typical pool of loans. We break it down into three groups—two groups of performing loans and the non-performing loans. The first group is the 53% of the deal that is performing and has a mark-to-market CLTV (combined LTV), using the Case-Shiller Index, of <100. Note that borrowers in this group have significant equity in their home (average mark-to-market CLTV of 78%). Based on this information, we would expect relatively few of these loans to default. Now look at the 30% of the performing loans with CLTV >100; these have an average mark-to-market CLTV of 115%. Recent performance would suggest that the default rate for this group will be much higher than on the lower CLTV group. And the non-performing group consists of the 16.8% of the loans that are already 60 or more days delinquent.

Our estimate is that 49% of aggregate loans (as measured by current balances) will default, at a loss severity of 54%, for a total loss of 26%. This is the rough equivalent of [defaulting all non-performing loans + all loans that have a CLTV > 100] at a 54% severity. A 26% loss estimate suggests that neither of the re-REMICs done off the WAMU 07-HY6 1A1 collateral will incur losses. However, the first re-REMIC WAMR 08-1 3A1 is apt
to be downgraded at some point, whereas ASG 09-1 A60 is not.

A more interesting comparison is shown in Exhibit 3. We show the credit enhancement of the underlying security, WAMU 07-HY6 1A1, the first re-REMIC WAMR 08-1 3A1, and the new re-REMIC ASG 09-1 A60, over time, under 2 scenarios. In the first scenario (base case), we assume 10% CPR, 1% monthly transition rate from the performing bucket (current and 30 days delinquent) into the non-performing bucket (60 or more days delinquent), and 50% severity. These prepayment and transition rates are close to current values, the severity is a bit higher than current values. The average prepayment rate of 2007 prime hybrids has been running 10%–12% per annum. The monthly transition rates have been running just over 1% per month, and severity is in the low 40s; the collateral loss under this scenario is 26%. In the second scenario we slow speeds down to 6% CPR and double the monthly transition rate from 1% to 2%. The collateral loss is 39% under this very severe stress. Note that the credit enhancement on the underlying collateral, WAMU 07-HY6 1A1, goes to zero in both cases as the security will clearly incur losses. The first re-REMIC, WAMR 08-1 3A1, builds enhancement under the first scenario; the bond prepayments faster than the credit enhancement disappears. Under the second scenario, with slower prepay and higher losses, the credit enhancement slowly evaporates, and the bond will actually incur losses. (This makes sense—the collateral losses total 39% and the enhancement is 33%.) The second re-REMIC, ASG 09-1 A60, builds credit enhancement in both cases. Even in the stress scenario (Scenario 2), after one year, the credit enhancement increases from 46% to 49%, after two years the credit enhancement increases to 53%, and after three years to 57%.

**EXHIBIT 3**
Credit Enhancement over Time for Various Tranches

[Graph showing credit enhancement over time for various tranches]

*Source: Intex, Amherst Securities.*
At the time of issuance in March 2009, a front sequential re-REMIC like ASG 09-1 A60 was priced at a 10% yield at 10% CPR. In order for this bond, with 46.35% credit enhancement, to incur a single dollar of loss, we would have to observe 77% of the pool defaulting with a 60% severity. That is very unlikely for this collateral, especially considering the fact that over half the loans have significant current equity in their homes. So the investor receives 10% yield for a short security where the chances of incurring losses are remote.

Who is buying the front sequential? The buyers are regulated institutions—banks and insurance companies, as well as total return money managers. In all cases, these institutions are comparing this instrument to similar duration agency mortgage product or corporates. Exhibit 4 provides a comparison versus other products at the time the security was issued. The re-REMIC seniors stack up very well to alternatives. It yields 10%, almost 700 bps more (or more than triple the yield) on agency hybrids or short agency CMOs. The yield is more than double the short fixed-rate ABS product. The re-REMIC also yields approximately 200 bps more than BBB corporates.

LIQUIDITY CONCERNS

Most of the re-REMICs will, out of necessity, be 144A transactions (private deals). The reason is that in a public re-REMIC, any underlying security that represents at least 10% of the resecuritization by principal balance is treated as a “significant obligor” under Item 1112 of Reg AB. This means Reg AB compliant disclosures would be required, including an update on the collateral based on current pool composition. That’s the same information that would be included in the 10-K for the underlying security. If the underwriter for the resecuritization is not the same as the underwriter for the initial deal, then the loan-by-loan information would not be available, and it would be impossible to do the update. Moreover, if the deal were public, a Sarbanes–Oxley certification will be required for the resecuritization trust. The issuer of the resecuritization will need to seek indemnification from the issuer of the original deal, warranting the quality of the initial information. There is no reason this would be forthcoming. In short, between Reg AB and Sarbanes–Oxley, if the dealer underwriting the resecuritization was not the original deal underwriter, it would be nearly impossible to do a public resecuritization.

Liquidity in private placements has historically been much worse than in public issues. This is because it has been difficult to get information (collateral, cash flows) on these securities. Given the fact that the underlying securities are publicly registered and most dealers are supplying the re-REMIC prospectuses to both Bloomberg and Intex, we believe that some of this new generation of re-REMICs will fare relatively well in the secondary markets. They would fare even better if there was a public registry of 144a deal offering memoranda (open only to qualified investors). This would allow users to spot check the cash flow results that they obtain on Intex and Bloomberg against the payment rules provided in the offering memorandum and assure themselves that the deals were modeled properly and there were no priority reversals or other surprises. We at Amherst have been advocating this and would happily register our deals.

WHY THIS RE-REMIC OPPORTUNITY?

The obvious question is—why was the market giving investors the opportunity to buy a bulletproof security at a 10% yield, a yield that is very attractive versus other fixed-income products? Either the back bond must be “too rich” or the underlying collateral “too cheap.” The answer was—the underlying collateral is too cheap.
At the time of the issuance of this bond, the largest differential between “expected principal return” defined as $100 \minus$ expected tranche losses and market prices is now highest in “prime” collateral. This will be where the potential to profitably configure the cash flows will be the greatest. Hence, more of the deals done during this period, including ASG 2009-1 A60, have been backed by prime collateral. For most of 2008, the majority of the re-REMICs were backed by Alt-A collateral, which represented the largest differential between expected principal return and market value at the time the deals were done. In retrospect, as fundamentals have continued to deteriorate and home price declines have accelerated, these early loss estimates turned out to be way too low.

Prime collateral dropped in price significantly in the few months prior to the issuance of this security. The quickly accelerating transition rates of this collateral were a sure sign that this collateral was not ratings stable. This was acknowledged in a March 19, 2009, Moody’s [2009a] report. In that report, Moody’s cautioned investors that “the vast majority of the senior securities issues in 2006 are expected to migrate to a rating ranging from Baa1 to B3, and … about 35% of the senior securities to rating below B3. For senior securities issued in 2007, about 20% are expected to migrate to a Ba1–Ba3 rating. The majority of senior securities from this vintage are expected to migrate to ratings below B3.” The Moody’s report, coupled with negative fundamentals, brought out selling, which drove prices down to levels where re-REMICs off this collateral became very attractive.

Meanwhile, the cycle of Alt-A downgrades has largely been completed. In an early 2009 study Moody’s [2009b] showed that 90.3% of the 2006 Alt-A deals had been downgraded and 85.1% had been downgraded below investment grade (2007 numbers are slightly higher—91.3% downgrades, 88.8% below investment grade). Unlike prices on prime securities, Alt-A prices are higher now than at the end of February.

FLEXIBILITY

We’ve all heard the mantra “this is a bulletproof bond” (after which loss expectations turned out to be much worse than anticipated, thus morphing a bulletproof bond into one that will take losses). What makes us think this situation is different? Two things:

1. Bonds like ASG 2009-1 A60 have an unprecedented amount of enhancement.
2. Rating agencies have gotten very conservative in rating new deals (and front sequential off the re-REMICs have achieved AAA ratings).

Investors should demand flexibility in their re-REMICs, and the cost of providing that flexibility is very low.

Playing the contrarian, let’s say we have it completely wrong, and these loss expectations turn out to be too low (again!). An exchangeable and recombinable feature that allows investors to sell the bottom piece of the bond in order to preserve the AAA rating on the remainder of the tranche is highly desirable. An example: ASG 2009-1 is divided into 15 building blocks: the G30, G35, G40, G45, etc., as shown in Exhibit 5. The G30 is the front approximately 30% of the cash flows; all other building blocks are in 5% increments. Thus, the G40 is allocated the 5% of the cash flows that corresponds to a 60% attachment point and a 65% detachment point (i.e., the G40 bears losses between 60%–65% of the deal). The pay rules are very simple: pay principal to the G30, then to the G35,
then G40, then G45, etc. Losses are allocated to the G100, then to the G95, then the G90, etc.

These tranches (building blocks) are then combinable. In fact, you will observe that the front sequential tranche of ASG 2009-1 is the A60. That means it is the front 60% of the cash flows, composed of [G30 + G35 + G40 + G45 + G50 + G55 + G60], as shown in Exhibit 5. If losses come in higher than expectations, it would be easy to sell the [G55 + G60] to maintain the AAA rating on the A50. If losses come in lower than expectations, an investor may want to buy the G65 and G70 to create the A70. In fact, the A75 is exactly the earlier re-REMIC, WAMR 08-1 3A1.

The mezzanine cash flows are similarly recombinalbe. If the A60 is the front tranche, and there is only one mezzanine tranche, it would be the M40. That is, it would consist of the bottom 40% of the cash flows consisting of eight tranches, the [G100 + G95 + G90 + G85 + G80 + G75 + G70 + G65]. Again, this is illustrated in Exhibit 5. This type of structure is very important for future flexibility.

**WARNING: ALL RE-REMICs ARE NOT CREATED EQUAL**

It is important to realize that all re-REMICs are not created equal. Simpler is better. While many re-REMICs are of the type we describe (i.e., supported by a single tranche of a prior REMIC, which is itself an unlevered senior security backed by first lien mortgages), which enables borrowers to easily look at the underlying collateral, other re-REMICs have more complicated structures. A number of re-REMICs are supported by multiple REMIC tranches, these deals are much harder to analyze, as each of the underlying transactions must be decomposed. Other re-REMIC securities are backed by a single tranche, but the credit support is provided by a number of tranches. This cross-collateralization feature also requires investors to decompose all the underlying tranches. Finally, some re-REMICs are backed by more levered tranches that are very sensitive to credit losses (i.e., they are not the most senior security in the structure). Thus, once the losses begin to attach, the bond is wiped out quickly. These re-REMICs are very difficult to value and should be avoided.

**CONCLUSIONS**

It is now clear (with 20/20 hindsight) that virtually all private label securities transactions were woefully under-enhanced at initial issuance. Moreover, in most cases, the bonds will actually take losses. However, most of these AAA securities are very thick tranches, with a high proportion of “good” loans. By providing more credit support through a re-REMIC structure, securities can be created that are truly AAA. Thus, re-REMICs are a very flexible tool in the current environment. They can be used to turn unwanted cash flows (formerly rated AAA) into those that fit into the current environment—a very well enhanced senior bond and a mezzanine bond that sells at a low price but is very levered with respect to performance.

It is important when purchasing a re-REMIC to have flexibility going forward. We think these securities are enhanced enough, but just in case we are wrong, the re-REMIC should be structured so that it can easily be transformed into a better enhanced structure without doing a second re-REMIC. Investors should demand that new re-REMICs have a “building block” structure, in which the tranches are exchangeable and recombinalbe.

**ENDNOTES**

1REMIC is short for real estate mortgage investment conduit and is the most common corporate form chosen for structured finance transactions.

2This is, of course, because insurance providers like the FDIC guarantee the return of those capital dollars.

**REFERENCES**


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